

Internal Revenue Service

Number: **201507004**
Release Date: 2/13/2015
Index Number: 1381.00-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

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Refer Reply To:
CC:PSI:5
PLR-120664-14
Date:
October 20, 2014

In Re:

Legend

Cooperative =

State A =

State B =

Consolidated Subsidiary =

Date =

Dear :

This is in response to a request for a ruling dated May 15, 2014, submitted on behalf of Cooperative by your authorized representative. The ruling concerns the application of cooperative tax law to the transaction described below.

Cooperative is a nonexempt rural cooperative telephone company that operates on a cooperative basis. Cooperative was previously granted exemption as a rural telephone company under section 501(c)(12) of the Internal Revenue Code but in recent years it is no longer exempt.

Cooperative is the parent and agent of an affiliated group ("Taxpayer Group"), which includes Consolidated Subsidiary. Consolidated Subsidiary is a corporation organized in State A in that is wholly owned by Cooperative. Taxpayer Group files its tax return on a consolidated basis as provided in section 1501.

Cooperative provides telecommunication services to rural customers in State A and State B. Consolidated Subsidiary provides no services to customers. Its sole function is to hold non-regulatory telecommunication assets for the benefit of Cooperative and in furtherance of Cooperative's telecommunication services. Entities that provide regulated services, like telephone services, create subsidiaries to hold non-regulated assets in an effort to comply with federal, state, and local regulations. The separation of regulated and non-regulated assets by the creation of a subsidiary assists telecommunications cooperatives in complying with such regulations.

On or before , Cooperative's management and board of directors identified internal and external pressures that required a change in the business model of providing telephone service to its customers. These pressures included shrinking plain-old telephone service ("POTS") access lines and declining access minutes of use, as customers migrated to mobile cellular services. Competition from cellular providers within the exchange area, and the loss of POTS lines, required investment in new technologies for its customers, including additional spectrum to provide advanced telecommunication services.

In , Cooperative, through Consolidated Subsidiary, purchased the MHz spectrum at issue. At that time, Cooperative considered the use of spectrum in support of future telecommunication services. As explained in more detail below, however, Cooperative eventually determined that the spectrum did not meet its long-term strategic objectives.

Through Consolidated Subsidiary, Cooperative was forced to sell the spectrum because of (i) unanticipated inadequacy of the spectrum, (ii) the onerous time constraints and "build-out" requirements imposed by the Federal Communications Commission ("FCC"), (iii) the anticipated large expense to implement and use the spectrum, and (iv) the need to fund the potential purchase of spectrum that would be more consistent with its strategic goals.

Cooperative reviewed its business needs and determined that the spectrum was inadequate to provide over -Mbps fixed service to its customers. The speed of service would be even less if a large number of customers were ultimately served. Moreover, because the spectrum is granted by the FCC, it comes with regulatory requirements. One such requirement is the obligation to build out the network and provide "substantial service" by 2019. Cooperative expected the build-out of the associated network to be very expensive.

Another factor in Cooperative's decision to sell the spectrum is the possibility of pursuing an upcoming MHz auction that would better fit the projected demands of customers and future customers. If Cooperative decides to pursue such spectrum, the funds from the sale of the MHz spectrum would be used to purchase the MHz spectrum.

As a result, on Date, Consolidated Subsidiary sold the spectrum at issue to an unrelated third party. The ruling request concerns the treatment of the gain arising from the sale of such spectrum.

Section 501(c)(12) of the Code contemplates that rural cooperative telephone companies may qualify as tax-exempt organizations. As the telephone business has developed, however, very few rural telephone cooperatives now qualify for this exemption; Cooperative falls into this category, and thus is a non-profit, but taxable, cooperative corporation.

Subchapter T of the Code, sections 1381-1388, provides the statutory scheme for taxing most cooperatives. Rural telephone cooperatives, however, are not governed by subchapter T, because of the exclusion provided by section 1381(a)(2)(C) for rural telephone cooperatives. When Congress enacted subchapter T in 1962, Congress excluded rural telephone cooperatives in order to avoid over-regulating them and, presumably, to provide them with more flexible tax treatment because of the necessary services they provided to under-served parts of the country. The underlying committee reports stated that cooperative corporations engaged in providing telephone service to persons in rural areas would continue to be treated the same as under prior law. See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 79, A127 (1962); S. Rep. No. 1881, 87th Cong., 2d Sess. 113, 310 (1962); see also, Rev. Rul. 83-135, 1983-2 C.B. 149.

Sections 1382 and 1388 of subchapter T placed new restrictions on the ability of cooperatives to deduct patronage dividends that were allocated but not paid; in many other ways, however, subchapter T codified the law that existed prior to 1962. Since its enactment in 1962, most of the development in the law regarding the taxation of cooperatives has occurred in cases under subchapter T. Thus while the cases and rulings interpreting subchapter T may not control the taxation of rural telephone cooperatives such as Cooperative, these authorities indicate the position of the Service and the courts on many of the issues that do control the taxation of rural telephone cooperatives.

Cooperatives are a unique form of business entity, which are democratically controlled by their patrons. In cooperatives, each member has one vote regardless of how much capital he or she contributed. Cooperatives are required to allocate their net margins from business done with or for their patrons back to such patrons in proportion to their patronage. This return of patronage-sourced income is bound up with the basic concept of a cooperative. Rather than using their net income to pay dividends to their shareholders, as a regular corporation would, cooperatives pay patronage dividends to

their members based on the amount of business that the member does with the cooperative. Patronage dividends are thus effectively price rebates for member-patrons. See CF Industries, Inc. v. Commissioner, 995 F.2d 101, 103 (7th Cir. 1993).

The taxable income of a cooperative is calculated in much the same manner as the taxable income of a taxable corporation, with one distinct difference: the income of a cooperative that is attributable to business done with or for patrons is excluded from or deducted from the income of the cooperative when such income is allocated to the cooperative's patrons. At the time this patronage-sourced income is allocated or (in the case of cooperatives not subject to subchapter T) at the time it is distributed, the cooperative's patrons realize the income. Patronage-sourced income flows through the cooperative and is taxed only once.

In order for the amount realized from the proposed sale of the spectrum to be deductible to Cooperative upon allocation, the amount must be patronage-sourced income, i.e., income derived from business carried on with or for Cooperative's patrons. While neither the Code nor the regulations provide a clear definition of patronage-sourced income, the courts have, in general, held that if the income at issue is produced by a transaction which is directly related to the cooperative enterprise, such that the transaction facilitates the cooperative's marketing, purchasing or service activities, then the income is deemed to be patronage income. Farmland Industries Industries v. Commissioner, 78 T.C.M. 846, 864 (1999), acq., AOD 2001-003 (citing Cotter & Co. v. United States, 765 F.2d 1102, 1106 (1985); Land O'Lakes, Inc. v. United States, 675 F.2d 988, 993 (8th Cir. 1982); Certified Grocers of Cal., Ltd. v. Commissioner, 88 T.C. 238, 243 (1987); Illinois Grain Corp. v. Commissioner, 87 T.C. 435, 459 (1986).

In Rev. Rul. 69-576, 1962-2 C.B. 166, the Service provided the following analysis of what it means for income to be patronage sourced:

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. If the income is produced by a transaction which actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, the income is from patronage sources. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources.

See also Rev. Rul. 74-160, 1974-1 C.B. 245 (ruling that interest income realized from loans made by the taxpayer was patronage source, because the loans "actually facilitated the accomplishment of taxpayer's cooperative activities, in that [the loans] enabled the taxpayer to obtain the necessary supplies for its operations.")

The sale of the spectrum by Consolidated Subsidiary will generate income for Cooperative.

Cooperative actively participated in the formation of Consolidated Subsidiary to insure that cellular service would be available to Coop's customers.

Courts have ruled in several instances that income from corporations organized by cooperatives to conduct activities related to the cooperative business is patronage sourced. In Farmland Industries, the taxpayer, a cooperative organized for the purpose of providing petroleum products to its patrons, sought to have the proceeds from the disposition of its stock in three subsidiaries classified as patronage-sourced income. In reaching its decision the court stated that its task was to determine whether each of the gains and losses at issue was realized in a transaction that was directly related to the cooperative enterprise, or in one which generated incidental income that contributed to the overall profitability of the cooperative but did not actually facilitate the accomplishment of the cooperative's marketing, purchasing, or servicing activities on behalf of its patrons, 78 T.C.M. at 870.

Emphasizing the need to focus on the totality of the circumstances and to view the business environment to which the income producing transaction is related, the Tax Court analyzed the reasons behind both the organization of the subsidiaries and their eventual disposition, Id. at 864, 865. First, it looked at whether the taxpayer's subsidiaries were organized to perform functions related to its cooperative enterprises. The subsidiaries had been organized to explore for, produce, and transport crude oil. The court determined that all of the subsidiaries were organized to perform functions related to the taxpayer's business and were not mere passive investments. Id. at 871.

In other cases, the direct relationship between the purpose of a cooperative business and its reasons for investing in a subsidiary were found to be dispositive on the question of whether income received from the subsidiary was patronage sourced. For example, in Astoria Plywood Corp. v. United States, 43 A.F.T.R. 2d 79-816, 79-1 USTC ¶ 9197 (D. Or. 1979), the court found that the income derived by a plywood and veneer workers cooperative from the cancellation of a lease on a veneer plant was patronage sourced, because the production of veneer was an integral part of the cooperative's business. In other words, the reason the cooperative leased the property to begin with had nothing to do with investing in real estate and everything to do with making veneer. Similarly, in Linnton Plywood Assoc. v. United States, 410 F.Supp. 1100 (D. Or. 1976), the court held that the dividends received by a plywood workers cooperative from West Coast Adhesives, a glue supplier which the cooperative helped to organize in order to supply its adhesive needs, were patronage-sourced income, since glue is essential for the manufacture of plywood, and the arrangement to produce the glue was reasonably related to the business done with or for the cooperative's patrons.

Cooperative's investment in Consolidated Subsidiary and its purchase of the spectrum was directly related to its cooperative business. Investing in a company in order to provide wireless telephone service is directly related to the business of a rural cooperative telephone company whose "reason for existence" is to provide telephone service to its patrons.

Cooperative's sale of the spectrum through Consolidated Subsidiary is also directly related to its cooperative business purpose.

In CF Industries, Judge Posner noted in his opinion that the court was not aware of any dramatic opportunities for tax avoidance by use of the cooperative form. 995 F.2d at 104. However, the court implied that a cooperative would be gaining an unfair tax advantage for its members if it were investing in businesses unrelated to its cooperative purpose and in effect running a mutual fund for its members on the side. Id. Judge Posner indicated that one type of transaction would not pass the mutual fund test: a temporary investment by a cooperative in securities. Id. Certainly, if Cooperative had taken its members capital and purchased a diversified portfolio of public company securities, there can be no doubt that the proceeds from such a portfolio should not and would not be patronage sourced. But Cooperative did nothing of this sort. It was an active participant through Consolidated Subsidiary in the purchase of the spectrum, which was directly related to its cooperative telecommunication services.

Accordingly based solely on the above, we rule that:

1. Taxpayer Group's gain on Consolidated Subsidiary's sale of cellular-phone spectrum, which was purchased for the purpose of potentially expanding its cellular-phone service to patrons of Cooperative, qualifies as patronage-sourced income.

2. Taxpayer Group's gain on sale of cellular-phone spectrum, which was purchased and sold by Consolidated Subsidiary in furtherance of Cooperative's cooperative function, is patronage-sourced income and, therefore, excludable under cooperative tax laws applicable to taxable rural telephone cooperatives.

This ruling is directed only to the taxpayer that requested it. Under section 6110(k)(3) of the Code it may not be used or cited as precedent. In accordance with a power of attorney filed with the request, a copy of the ruling is being sent to your authorized representative.

Sincerely yours,

Paul F. Handleman
Chief, Branch 5
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)